The UK Green Taxonomy

November 2022

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Environmental, Social, and Governance

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This report is based on a roundtable discussion of the APPG on ESG held in September 2022, evidence provided by Green Taxonomy experts, case studies submitted by the group's sponsors, and additional research by the APPG secretariat, College Green Group. It is funded by the APPG's sponsors: BAE Systems, Bayer, CBRE Investment Management, CSR Accreditation, EMK Capital, ESG Book, KPMG UK, Rigby Group, Sage, Shore Capital, Six Group.

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- Financial Reporting Council
- The UK Sustainable Investment and Finance Association
- Principles for Responsible Investment
- The International Regulatory Strategy Group
- The Confederation of British Industry
- Impact Investing Institute

About the All-Party Parliamentary Group on Environmental, Social, and Governance

The APPG on Environmental, Social, and Governance was founded in July 2021 with the goal of encouraging engagement between legislators and industry and improving discussion on the changing role of ESG in domestic and global finance. In the intervening months, events have been held with expert speakers from across industry, academia, and Parliament.

These events have focused on a variety of subjects spanning environmental, social, and governance issues and include both talks from experts as well as roundtable events which allow for input from a variety of industry professionals within one discussion. The group's first report, which made recommendations for standardising and regulating ESG performance and assessment, was published in April of this year.

Since the Government's introduction of a UK Green Taxonomy, the APPG on ESG has supported its development and lauded the Government's commitment to helping investors – retail and corporate – understand where their money can make an impact. This report is the culmination of two evidence sessions held by the APPG, and contains recommendations and counsel devised from these evidence sessions with industry, stakeholders, and academics.

The APPG is chaired by Alexander Stafford MP, its original founder. The group's membership includes 20 parliamentarian officers, as well as an advisory board made up of leading businesses and investors. Additionally, leading academics, policymakers and regulators, both in the UK and internationally, regularly feed into and support the APPG's work.

Notes from the Chair of the APPG

Britain has always been the torch-bearer in sustainability legislation – the beating heart of global finance, investing, and banking; the first major economy to legislate on climate change, the first to establish a net zero target and the first to require companies to report on modern slavery in their supply chains – but our tardiness to release our Green Taxonomy means we have fallen behind.

The EU's Green Taxonomy, which the UK helped to write before Brexit, is now seen internationally as the benchmark despite its well-documented flaws. In order to regain our place as a world leader in this area, as I understand it from discussions with those who contributed to the evidence sessions, we must, firstly release the UK Green Taxonomy consultation as soon as possible, and secondly work diligently to ensure that our Taxonomy is credible, useable, and interoperable (see Figure 1.).

Firstly, credible because the Taxonomy must be rigidly science-based in order to achieve its goal of ending greenwashing and supporting sustainable investing. Above all, a Green Taxonomy should be *green*. If even one carbon intensive activity, such as power generation from natural gas, is included as a 'green' activity, it will fail. Preserving the Taxonomy's integrity is of critical importance and lies at the heart of many of the recommendations that feature in this report. As further evidence of the necessity for credibility, the EU's Taxonomy contains serious scientific fallacies, which we must not replicate. The Government has committed to ensuring that our Taxonomy is based in fact and upon consultation, and I encourage the Government to stick to this commitment.

Figure 1. Three principal Taxonomy priorities

Credibility
For a Taxonomy to effectively address greenwashing while sending the right market signals to maximise the flow of capital to green assets, it must be credible, based on both scientific expertise and wide consultation.

Usability
Users of the Taxonomy face resource constraints, both in terms of capacity and expertise, the Taxonomy must therefore be as user-friendly and familiar to market participants as possible.

Interoperability
The UK's Green Taxonomy should be interoperable with other ESG policy instruments and Taxonomy regimes in the EU, and globally, and while meeting the requirements of the UK's green economic and financial objectives.

Secondly, the UK Green Taxonomy must be usable so that British firms are not tied up in red tape and to avoid hindering business. Simply requiring more compliance, more boxes to tick, would be a failure for two reasons. Firstly, it only serves to reduce firms' efficacy and operational capacity – which should not be the aim of any regulation or legislation. Secondly, and perhaps more importantly, box ticking does not lead to a change in attitudes. If companies regard this Taxonomy as some form of compliance burden, it will have failed. As was repeated in the evidence session, the Taxonomy should be designed as a tool to facilitate investment, not a barrier.

Thirdly, our Taxonomy should be interoperable so as not to hinder firms from taking full advantage of Brexit and operating across the world. The UK has an opportunity to lead the world in green finance by creating a taxonomy which has the potential to be universal; we must make sure to keep this in mind at all times. In a global financial marketplace, UK investors and many corporates will already use the EU Taxonomy. Thus, interoperability has a bearing on usability as well as UK leadership. For this reason, it is the right choice to follow similar lines to the EU's Taxonomy, so that firms wishing to align themselves to both can do so.

As above, one of the things most stressed at the evidence sessions was the need for the UK to act quickly and decisively in building our Green Taxonomy. We must work to fully utilise our second-mover advantage: we can learn from the many failures of the EU's Taxonomy, but still build a Taxonomy on which others will be modelled. Any more delay will mean we fall further behind our international competitors and may miss the chance to create a globally-followed, strictly science-based Taxonomy.

This report is the result of much hard work by the All-Party Parliamentary Group on ESG. The contents are based on our evidence sessions, and discussions such as these – with businesses, stakeholders, and academics – must continue as we progress the Taxonomy. It must also be acknowledged that designing a Taxonomy will be difficult, complicated, and demanding. The purpose of this report is not to hinder or harry the Government's work to implement the UK Green Taxonomy, rather to feed into its development. The APPG's core aim is to support the Government in its endeavour in, in the words of the Prime Minister in the *Greening Finance Roadmap*, "cementing the UK's status as the best place in the world for green and sustainable investment"[1].

Alexander Stafford, MP for Rother Valley and chairman of the APPG on Environmental, Social, and Governance

1 HM Treasury, 'Greening Finance: A Roadmap to Sustainable Investing', October 2021

Executive Summary

In October 2021, the UK Government published a roadmap for the UK Green Taxonomy alongside new Sustainability Disclosure Requirements (SDR) that together aim to improve ESG reporting for corporations and investors, and help root out "greenwashing" attempts. The document sets out the direction for the UK's Taxonomy and explores variables facing the Government ahead of its Taxonomy journey.

This report is based on consensus informed by roundtables and evidence sessions with a wide range of financial and scientific experts, together with corporate executives and investors from across Europe; and driven by the All-Party Parliamentary Group on Environmental, Social and Governance's commitment to improving non-financial reporting. Other headline priorities of the APPG include tackling greenwashing, widely viewed as the Green Taxonomy's primary purpose, and ensuring frameworks, metrics and methodologies are applied to both investors and companies with the minimum amount of burden.

The dominant reference point for this report was the European Union's Green Taxonomy. The EU has set the blueprint for others to copy, including the UK, but in the APPG's view, it has committed unforced errors to learn from, notably through the inclusion of natural gas as a transitional fuel, and by failing to present the Taxonomy as a rigid scientific resource to assist investment in genuinely green assets, leading to fierce and unhelpful political deliberation across EU capitals.

This report takes heed of those errors, and calls for a credible, science-based UK Taxonomy, which is purpose-driven and allied with an array of necessary policies and instruments such as SDR and transition plans. The APPG urges stakeholders to bear in mind that the Green Taxonomy is but one instrument among many. The scientific dimension is pivotal. Establishing appropriate metrics and thresholds for all economic activities that contribute to emissions and cause environmental degradation is a huge undertaking.

In onshoring the EU Taxonomy, much of this work has already been done. However, the EU27 does not compare like-for-like with the UK's single market. Furthermore, Britain is home to the City of London and has traditionally had a cleaner energy mix than some of its European counterparts. An overarching recommendation of this report is for wide and regular consultation, both with scientific experts and market practitioners. Contributors to the report were adamant that this approach would optimise the initial UK Taxonomy and ensure it remained fit for purpose, provided that it was married with transparency. Regular consultation would also ensure the UK takes advantage of its assets in this domain, namely its strong financial services industry, and huge pool of world-class scientific expertise and innovation.

Consultation is needed because fundamentally, we need to get this right. Stakeholders need to be confident that green investments are indeed green, otherwise precious credibility will be squandered. The Taxonomy should therefore be not only rigid, but binary, there is no third way, which is why an additional transitional taxonomy, or equivalent instrument, is strongly recommended. We must not lose sight of the fact that only a small fraction of companies' operations will be aligned with the Taxonomy, a broader transitional tool will account for a much greater proportion, which is necessary to decouple the wider economy from fossil fuels.

This report strongly recommends that the Government avoids a transitional designation for the simple reason that stakeholders need to be confident that green investments are indeed green, otherwise precious credibility will be squandered. The Taxonomy is not only rigid, but binary, there is no third way, which is why an additional transitional taxonomy, or equivalent instrument, is strongly recommended. We must not lose sight of the fact that only a small fraction of companies' operations will be aligned with the Taxonomy, a broader transitional tool will account for a much greater proportion, which is necessary to decouple the wider economy from fossil fuels.

Credibility, founded upon science and consultation, constitutes one of the three main pillars of this report, alongside usability and interoperability. Since its inauguration in spring 2021, the APPG has pushed for improved framework conditions – the Taxonomy along with SDR being prime examples – with the needs of investors and companies, particularly SMEs, foremost in mind. The huge volume of metrics and thresholds, contained within the Taxonomy that together define sustainable investment, must be as easy to interpret and apply as possible.

The other side of the usability coin is interoperability between taxonomies. Many UK-based investors and businesses already use the EU Taxonomy. The more they mirror one another, the more usable the UK's will be, provided that specific circumstances are taken into account effectively, for instance, some metrics included in the EU taxonomy do not apply in a UK context. Trade-offs at the expense of interoperability are inevitable, but they should be kept to a minimum.

Interoperability is essential too for the simple reason that investors operate globally. The more joined up green finance markets are, the better. In redeveloping, if not reinventing, the EU taxonomy for the UK, the Government also has an invaluable opportunity to build on the momentum of COP26 and project global leadership. This can be achieved through bilateral and multilateral engagement to build bridging taxonomies, such as the EU's Common Ground Taxonomy with China, and learn good practice along the way as global partners strive for superior ESG standards.

In this respect, the UK has what has become known as second-mover advantage, but for that advantage to be taken, the Government must first deploy the Taxonomy. After a strong start, the process has stagnated. A consultation set to be released in 2022 has not materialised. The Taxonomy was due to be published by the end of 2022. This report calls for the consultation to be released as soon as possible and for the Government to make up for lost ground as quickly and energetically as possible.

The timetable needs to be sped up, not least because the SDR regime has moved on apace, but it is of little use without a working definition of sustainable investment. Moreover, if the taxonomy is to root out greenwashing, it needs also to be understood by and gain the confidence of both commercial and retail investors. Therefore, this report calls for effective communication, not only of the Taxonomy's purpose and limitations, to stave off politicisation, but also on simply how it functions and how to use it so that investors can understand and be reassured.

Introduction

Before discussion on the Taxonomy can begin, it is important to understand the landscape in which this report has been written. The UK Government set out its stall for a Green Taxonomy in HM Treasury's document, 'Greening Finance: A Roadmap to Sustainable Investing' (henceforth, the *Greening Finance Roadmap* or the *Roadmap*), which was published in October 2021[2.] Since then there has been little information forthcoming from the Government on what form, shape, or scope the Taxonomy would take. For this reason, this report uses what was set out in the *Roadmap* as a basis for recommendations and discussion about the Taxonomy.

The *Roadmap* gives three clear aims of the UK Green Taxonomy: firstly, it will create clarity and consistency for investors to allow them to easily compare companies' and funds' sustainability performance to help inform financial decisions. Secondly, it will improve general understanding of companies' environmental impact and sustainability. Thirdly, the Taxonomy will provide a reference point for companies, this will allow them to measure their own, and their competitors', performance, and achievement on their transition plans.

As well as outlining the aims of the Taxonomy, the *Roadmap* sets out the approach the Government will use to produce it. In particular, the Government commits that our Taxonomy will draw on the EU's Taxonomy – which Britain helped to design before Brexit. Specifically, our Taxonomy will be based on the same six environmental objectives as the EU's Taxonomy (see Figure 2.) it will include specific Technical Screening Criteria (TSC) for each activity, as well as a requirement to do no significant harm to any of the six environmental objectives.

Figure 2. The Taxonomy's six environmental objectives

- Climate change mitigation
- Climate change adaptation
- Sustainable use and protection of water and marine resources
- Transition to a circular economy
- Pollution prevention and control
- Protection and restoration of biodiversity and ecosystems

As the *Roadmap* points out, the most labour-intensive part of introducing the Taxonomy will be defining the TSC for each of the Taxonomy's objectives. The document commits to ensuring that these TSC are evidence-based, will be advertised clearly to business, subject to public consultation and made through statutory instruments to. ensure Parliamentary scrutiny.

The timeline given in the Roadmap has, however, slipped severely as it aims to consult on a draft of the UK TCSs in the first quarter of 2022. The first batch of TSC are now expected by the end of 2023.

2 Ibid

The optimisation of the UK Green Taxonomy is supported by world-class expertise through the newly established Green Technical Advisory Group (GTAG), an independent group, made up of market experts, and the Energy Working Group (EWG), combined with a UK Treasury-led consultation and review. At the time of writing, however, the consultation is yet to be released.

Methodology and purpose of this Report

In formulating the recommendations enclosed in this report, the APPG gathered evidence from contributors in an effort to form a consensus based on discussions with industry experts, academics, and stakeholders. From these first-hand accounts, the APPG has synthesised eight headline recommendations for the UK Green Taxonomy, as well as further, specific recommendations. The core purpose of this report is to commend these recommendations to Parliament and Government to encourage and help shape the development of the UK Green Taxonomy.

This evidence was gathered in two separate evidence sessions held with key stakeholders and members of the APPG's advisory board. The first evidence session was held on the 22nd of September 2022, and was a discussion between the Green Finance Institute (GFI), which acts as the GTAG secretariat, parliamentarian officers of the APPG, and the APPG's advisory board.

Ryan Jude, programme director for the Green Taxonomy at the Green Finance Institute, discussed its role in inputting into HM Treasury's development of the Taxonomy. In particular, the APPG heard GTAG's view on how our Taxonomy could interact with the EU's, how businesses and regulators will use the Taxonomy, and how the Taxonomy can be linked with businesses' transition plans.

The second evidence session consisted of sequential private meetings between the APPG and stakeholders. A list of the contributors is listed under the acknowledgements, and the APPG would like to thank them for their time and invaluable support in this report. This allowed contributors to submit evidence securely and privately, leading to a more expansive and open discussion. Almost all the recommendations below have been derived from this session, and it represents a significant amount of first-hand data and knowledge from stakeholders who will have a huge amount of involvement in the Taxonomy.

After compiling the evidence from the two sessions, the APPG has written this report specifically to feed into the Government's plans for the development of the UK Green Taxonomy. Most of the comments and recommendations of this report are based upon consensus derived from these evidence sessions.

Part one of this report explores the basis of the UK Green Taxonomy, and how it could be improved as compared to the EU's considering the UK's unique asset: the City of London. The second section covers the three areas that must be key priorities for the Taxonomy: credibility, usability, and interoperability. The final part examines the route to implementation, while driving home the UK's role as a world leader in this sector.

Headline recommendations

1. The UK must launch its Green Taxonomy as soon as possible to avoid losing second-mover advantage and the chance to claim leadership status in the global transition to net zero.
2. The UK Green Taxonomy must be credible, usable, and interoperable.
3. The Treasury must begin its consultation as soon as possible, which was originally planned for earlier this year.
4. The UK Green Taxonomy must be science-based in order to be credible.
5. The UK's Green Taxonomy should not include transitional activities that are not feasible and actionable, as this will fail to address greenwashing and only further exacerbate disclosure and reporting discrepancies
6. The Government must continue to consult with all relevant stakeholders during the development of the Green Taxonomy and once it has been published.
7. The Government must develop guidance in consultation with a wide range of working groups, businesses – particularly SMEs – and other stakeholders in order to make the Taxonomy as usable as possible.
8. The UK must take full advantage of any assets available to us, for example world-class scientific expertise, the renewable energy sector, or the City of London, when devising the UK Green Taxonomy.

1. Context: The European Union and the United Kingdom

1.1. The blueprint for a UK Taxonomy

The APPG fully anticipates that the six objectives underpinning the EU Taxonomy together with its structure and functionality will be adopted (see Figures 2 and 3) for the UK Taxonomy, a common refrain heard throughout the research and evidence sessions for this report.

Since April, larger UK companies and financial institutions have been required to align their ESG reporting with the Taskforce on Climate-Related Financial Disclosures (TCFD), a world first. A revised Green Finance Strategy, together with the Transition Plan Taskforce and Sustainability Disclosure Requirements are all scheduled for 2022-23. Despite this, the APPG would like to see faster movement with the Green Taxonomy, a year on from the *Roadmap*. This was stressed by many of the stakeholders who spoke to the APPG. In particular, the UK Sustainable Investment and Finance Association (UKSIF), who told the APPG:

> *We are currently behind track, and the market needs to know what is happening, there's no real plan. Something is needed from the Government to give everybody an idea. The UK has made good commitments, and we need to stick to those. The UK can't fall behind after the successful COP26.*

1.2. Lesson learned from the EU

In June 2020, the EU passed regulation 2020/852, which defined the new Green Taxonomy and how it functions[3]. The new regulation gave the European Commission delegated powers to set the thresholds, known as Technical Screening Criteria, which determine whether an economic activity qualifies as green or not (see Figure 3 for a description of the EU Taxonomy).

3 Official Journal of the European Union, 'Commission Delegated Regulation (EU) 2022/1214 of 9 March 2022 amending Delegated Regulation (EU) 2021/2139 as regards economic activities in certain energy sectors and Delegated Regulation (EU) 2021/2178 as regards specific public disclosures for those economic activities', March 2022.

In December 2021, it emerged natural gas was likely to be included in the EU Taxonomy, and was duly adopted via secondary legislation in March 2022[4]. Under the EU's delegated act, natural gas was given a partial exemption from the 100g CO_2 equivalent per kWh TSC threshold applied elsewhere[5]. The fossil fuel was re-categorised as a 'transitional' activity with a much higher threshold of 270g CO_2 equivalent per kWh until the expiry of this special category after 20 years.

On 31 December 2021, the EU's independent Platform on Sustainable Finance was invited to provide feedback on the delegated act to be completed in less than two weeks, later extended to 21 January. "Our intention is to adopt the act as soon as possible," said a Commission spokesperson at the time[6].

Figure 3. How to determine whether an activity aligns with the Green Taxonomy

Contribute

Substantially contribute to at least one of the **six environmental objectives**.

DNSH

Do no significant harm (DNSH) to any of the **other five environmental objectives**.

Social

Comply with **minimum social safeguards**.

Activities that are Taxonomy 'aligned' fulfil the three criteria, including the technical thresholds. An activity is 'eligible' if it fulfils the substantial contribution (SC) criterion for at least one of the six environmental objectives (Figure 2.).

The EU's behaviour sparked a furious response from state as well as non-state actors. Spain, Austria, Luxembourg, and Denmark wrote a joint letter to the Commission stating: "We find the new draft problematic both from a political and technical point of view"[7].

4 Euractiv, 'Commission to table green investment rules for gas and nuclear early next year' December 2021

5 Official Journal of the European Union, 'Commission Delegated Regulation (EU) 2022/1214 of 9 March 2022 amending Delegated Regulation (EU) 2021/2139 as regards economic activities in certain energy sectors and Delegated Regulation (EU) 2021/2178 as regards specific public disclosures for those economic activities', March 2022.

6 Politico, EU enters endgame in fight over green investing rules, January 2022

7 Brussels sued for including fossil gas in EU's green finance taxonomy, January 2022

Elements of the EU experience do not translate to the UK: one country, one energy mix, compared to 27, which is reflected in the campaigns backed by different EU member states for different thresholds – France is known to have lobbied for the inclusion of nuclear8. Germany and eastern European states pushed for the inclusion of gas[9 10].

Furthermore, because the thresholds were introduced through secondary legislation under powers given to the European Commission under regulation 2020/852, they could only be challenged by repealing the regulation itself. Nevertheless, there are important lessons for the UK to learn.

The introduction to this section of the report emphasised the need for the Government to state clearly the Taxonomy's purpose. The instrument is there to build trust, which stems from scientific fact as the basis of the Taxonomy (see section 2). Underestimating the importance of science, and clearly stating as such, is the critical error committed by the EU in the APPG's view.

The group fully recognises the transitional properties of natural gas, along with environmental arguments for nuclear, but in line with the clear majority of stakeholders who fed into this report, the group takes the view that activities can only qualify as green if they are scientifically proven as such. In both cases, there are trade-offs to be made, but the science cannot be compromised.

In September 2021, the EU launched its green bond scheme. The €250bn issuance accounted for a third of the €800bn COVID-19 Recovery Fund, the subject of fierce political wrangling among European capitals during the pandemic11.

Alongside the green bond allocation, applications for funds are required to meet green benchmarks tied to the Taxonomy. As a result, the instrument, which started life as a "very green" finance tool, according to one testimony, came to be seen as a policy to manipulate by some and a threat by others, setting in motion a fierce lobbying battle for inclusion in the Taxonomy or risk being starved of investment against the backdrop of post-pandemic recovery, as opposed to the greening of the EU economy.

The underlying error made by the EU, according to several stakeholders consulted for this report, is that it failed to communicate the Taxonomy's purpose, to aid private investment in genuinely sustainable assets, and its essential character as a "rigid" policy instrument that was never intended to cover the majority of economic activities, only those that are scientifically determined to be green. The communication breakdown rendered the Taxonomy a target for lobbying and turned it into a contentious subject.

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8 RFI, 'France leads charge to label nuclear power as 'green' under EU Taxonomy rules', October 2021

9 Euractiv, 'German industry scores gas win in EU Taxonomy' February 2022

10 Reuters, Poland, others step up push for gas in EU green finance rules: document, March 2021

11 Financial Times, Brussels to issue 'Covid green bonds' as part of pandemic recovery effort, September 2021

The UK Taxonomy may not face an identical scenario of politicisation, but the prospect of it being misunderstood and manipulated is real.

A further criticism of the EU approach was to launch a limited consultation with the 57 members of the Platform on Sustainable Finance, lasting just two weeks, later extended to three. This is the second error in the APPG's view, given the importance of scientific evidence and expertise to anchor the Taxonomy, combined with its significance for a wide range of financial institutions and corporations operating across the globe.

In its discussions with the APPG, UKSIF was adamant that transparency and consultation should be prioritised. "We want to make sure that this Taxonomy is always up-to-date with the changes in technology and the industry as it develops. If you have a Taxonomy that's always five years behind, then it can quickly become discredited," they told the APPG. The EU and the UK have both committed to revising the Taxonomy every three years, but it is essential active consultation takes place between those intervals.

1.3. A UK Specific Taxonomy

An overarching consideration of the APPG's Green Taxonomy roundtable was the City of London and its status as an international hub of global investment and key representations of leading global financial services firms. A UK Green Taxonomy has the potential to influence the flow of international capital towards green and more sustainable assets, and can thereby support international conglomerates' transitions to net zero in line with science-based targets.

In his testimony to the APPG, Dr Theodor Cojoianu, green finance professor at the University of Edinburgh and a member of both GTAG and the EU's platform on Sustainable Finance, stated that the South African Green Taxonomy – which is also based on the EU's – is targeted towards domestic markets and green foreign, direct investment.

Regardless of whether the South African Government took this approach, professor Cojoianu stressed that the UK must map domestic and international flows and trends to ensure the UK Green Taxonomy, along with accompanying requirements such as SDR, reflect this landscape. Given the vastness and global reach of financial services in this country, consultation should be wide and deep to ensure these flows are factored in accurately.

Martina Macpherson, who spoke at the APPG's Green Taxonomy roundtable, stated that unfortunately, consultation of key stakeholders has often been lacking. "The broader value chain – capital markets, credit rating agencies, lending institutions, data providers – have been traditionally overlooked in many of these regulatory decisions around better transparency and disclosure, especially in the first stages of the EU's disclosure regulation which initially only included corporate and investment implications." She added: "I think we probably do not want to involve them too late again. Instead, they need to be included early on in the assessment and engagement process, because that is ultimately where the different parties can align on standards, aggregate their ESG information and intersect in relation to capital markets and investment decision-making, and hence ultimately where capital flows are being determined."

Furthermore, in having such a phenomenal volume of global financial services operating in its jurisdiction, the UK is in a position to build and implement a Taxonomy to encourage investment, not only in green technologies and projects in the UK, but the rest of the world.

Aside from this global reach, the UK is one single country, as opposed to the EU's 27 member states. The wide disparities within the EU between lignite-burning countries and those with more diversified and greener energy mixes are not comparable, which means the UK Taxonomy can be targeted and effective.

Section recommendations

- Ensure the Green Taxonomy is scrupulously science-based to ensure it works effectively and gives the right signals.
- Consult widely over realistic timelines.
- Ensure the purpose of the Taxonomy is clearly communicated and efforts are made for it to not be a target for lobbying and politicisation.
- Improve the usability of the 'do no significant harm' criteria to ensure businesses and projects are able to align that otherwise would not under the EU Taxonomy.

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2. Green Taxonomy delivery: credibility, usability and interoperability

2.1. Science-based

A well-known antidote to market failure is to build trust between buyers and sellers. Typically, it is the state's responsibility to help build that trust with a variety of regulations and policy instruments, of which the Taxonomy is just one example.

It stands to reason that consensus, backed by scientific evidence, are key ingredients in building trust in a technical instrument like the Green Taxonomy. However, as we have seen with the EU and transitional fuels, making science the foundation of the Taxonomy is not straightforward.

Beyond the political dimension, there are obvious challenges in translating testimony and evidence provided by scientists into a workable Taxonomy with appropriate thresholds. There are difficult distinctions to be made between what is quantifiable and what is qualifiable, the metrics to use and the methodologies behind them. And in the absence of robust data, suitable proxies and methodologies need to be devised to help ensure businesses meet their disclosure requirements without wasting time trying to source data that in some cases does not even exist. All these considerations need to be backed by scientific and technical expertise.

The UK is in a strong position. The science-led Climate Change Committee is an important pillar of UK environmental policy and the Government has taken the right approach with the Taxonomy by appointing an Energy Working Group, several members of which provided evidence for this report, which advises on thresholds for energy-related activities; and creating the external Green Technical Advisory Group, tasked with advising on implementation and design of the Taxonomy. More broadly, the UK is a world leader in science, including renewable energy. In March, His Majesty's Treasury launched a consultation on the Technical Screening Criteria.

Nevertheless, more can be done, a clear majority of organisations and individuals consulted for this report stressed the need for the consultation to be published sooner rather than later, a view shared by the APPG and a headline recommendation of this report. The same applies to the Taxonomy itself, although as one APPG roundtable participant put it, echoing a comment made at the APPG's Taxonomy roundtable discussion that resonated with participants, "we need to get this right". The need for urgency should be balanced with ensuring necessary processes, including consultations, are deployed appropriately and not rushed.

Consensus will not be built around one consultation. The APPG would also like to see open consultation on specific sectors, and discussed with relevant experts. For buildings, some metrics listed under the EU Green Taxonomy regulation are not suitable for the UK (see case study in section 2.4.1.)[12.]

The APPG is mindful that some businesses will continue to exaggerate their green credentials, whether purposefully or through failing to use the Taxonomy appropriately. Again, this concern leans on the importance of scientific evidence and wide consultation to develop and sustain a Taxonomy that is fit for purpose.

Returning to market failure, as more and more investors seek sustainable investments, it is incumbent on the Government to introduce a tool that distinguishes the green from the non-green. If investors are faced with two green portfolios, one of which includes natural gas, while the other is legitimately green, but both qualify as aligned with the Taxonomy, not only is market failure persisting, it is being enabled.

12 The Green Technical Advisory Group, 'Advice on the development of a UK Green Taxonomy' October 2022

In October 2022, the Austrian Government filed a lawsuit against the EU over the inclusion of nuclear energy and natural gas in its Green Taxonomy[13]. "What I am resisting with all my strength is the attempt to greenwash nuclear and gas through the back door," said Austria's Environment Minister, Leonore Gewessle[14]. Vienna has invited other member states to join. Two weeks earlier, five NGOs, including WWF, took legal action against the European Commission, citing a clash with EU climate law15. The UK Government shares the same vulnerability, having committed to net zero by 2050 in law in 2019. If a green transition is not seen to be happening, through the introduction of the Taxonomy among many other environmental policies and instruments, HMG could suffer similar legal action.

Professor Gioia Falcone of Glasgow University raised the broader risks of litigation to the Government and, by extension, the taxpayer, with the APPG. The UK has and continues to amass environmental liabilities brought about by hazardous economic activities, a prime example being the decommissioning of the Sellafield nuclear power plant, which could come to £260bn – the original price tag was £110bn[16]. As companies go out of business, the liabilities are automatically transferred to the public balance sheet, a reminder of the need for a Green Taxonomy, and more broadly, for ESG and corporate responsibility to be embedded more in corporate reporting and culture respectively.

2.2. Data and thresholds

The data and metrics incorporated into the Taxonomy and the accompanying technical screening criteria, as the term suggests, are highly specialised. For the most part, the APPG is reluctant here to make definitive recommendations, but having received testimony from a broad range of experts, including three academics on the Energy Working Group, there are some clear areas of convergence to share in this report.

This section first explores environmental data, chiefly life-cycle assessments (LCA), which were strongly recommended to the APPG, and associated technical screening criteria, before going on to address the financial data used in the Taxonomy that links activities with environmental impact.

2.2.1. Environmental data and thresholds

A life-cycle approach was highly recommended by contributors as the metric captures the whole environmental picture, giving visibility into whether environmental benefits are being delivered, which is essential to the integrity of the Taxonomy. Moreover, under the do no significant harm principle, a positive contribution cannot atone for environmental damage under the remaining five environmental objectives. An LCA analysis helps satisfy this requirement.

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13 euobserver, 'Austria sues EU commission over labelling gas and nuclear "green"', October 2022

14 Ibid

15 Euractiv, 'Brussels sued for including fossil gas in EU's green finance Taxonomy', 19 September 2022

16 Guardian, 'UK's nuclear waste cleanup operation could cost £260bn', 23 September 2022

Professor Patricia Thornley, director of the Energy and Bioproducts Research Institute at Aston University, demonstrated two clear advantages of a life-cycle approach. The APPG was shown the example of blue hydrogen inputs which involve carbon; and outputs, which are carbon-neutral. An LCA reflects both, providing a net score, and accounts for unintended consequences. Secondly, an LCA is not confined to a single territory, and given that the UK is a net importer of goods, LCA metrics are a necessary tool to ensure emissions that occur overseas are accounted for.

Professor Thornley, among others, stressed that methodologies are complex and are composed of numerous data points, not all of which can be met when trying to accumulate information across borders. Uncertainty is therefore an inevitability to acknowledge and work around. This point was welcomed by the APPG, for whom a key concern is not forcing businesses to strive for data that may not be easy to source. The drive for accuracy has to be balanced with a commitment to limiting reporting burdens.

Asked about the level of burden, Professor Falcone – who also advocated the use of LCA – warned the APPG that these metrics are reliant on expertise, although commercial solutions are available. But again, the main impediment is accessing data that needs to be accounted for.

Questioned on the use of LCA, UKSIF suggested a parallel regime for SMEs, consisting of simpler metrics with easier-to-acquire or approximate data. If larger firms are struggling with the Taxonomy, there is little hope that smaller ones will be able to cope. An important consideration in this respect is that an unyielding Taxonomy is likely to lead to less accurate disclosures, leading to greenwashing, whether intentional or not. The director of sustainability at a global tech company warned this danger is compounded by a lack of expertise and a general skills gap. SMEs are particularly exposed as they are likely to lack the resources to recruit specialists to undertake life-cycle assessments and other complex metrics. The sustainability director added that as a starting point, it needs to be clearer what to report on, how to gather and analyse data, and how to present data, underlining the need for support and guidance.

Higher interoperability will be gained through adopting the EU's metrics en masse. Nevertheless, the APPG encourages the architects of the UK Taxonomy to thoroughly explore trade-offs and be prepared to use alternative metrics in those instances where the burden stemming from EU metrics is too high. This calculus should be transparent and consulted upon.

The UK has assured a minimum level of interoperability with the EU by adopting the same framework. Using the same metrics would enhance interoperability further, however, the UK can choose to alter thresholds in line with the position and configuration of its own economy comparatively less additional compliance cost encumbered on businesses. There is an important debate to be had in this space, higher thresholds will lead to the UK setting the gold standard for a Green Taxonomy, which it is well-placed to do as an advanced economy.

UKSIF shared its view with the APPG that natural gas could conceivably be designated as green in a country far behind the UK in terms of renewables, if it were dependent on coal for instance, with little prospect of transitioning to renewables in the medium term. That is not to say, however, that less advanced economies cannot show the UK how to improve upon the EU's Taxonomy model. South Africa, for instance, has incorporated declining thresholds, according to set timelines.

Making the TSC more stringent over time is fully anticipated in line with scientific and technological change together with actual progress towards meeting sustainability objectives. One suggestion put forward by contributors was to leave this process to a standing committee of experts to ensure the decision-making was insulated from political interference. The APPG agrees with this view, but would still welcome a discussion around the South African approach, as it would support UK efforts to set a higher standard for a Green Taxonomy and exert global leadership in this domain.

A third member of the Energy Working Group, who also sits on the Committee on Radioactive Waste Management, Professor Claire Corkhill, spoke to the APPG about the narrow circumstances in which nuclear energy can be considered Taxonomy aligned. Nuclear energy is emissions-free, but radioactive waste is hazardous and long-lived. Consensus on safe disposal is not in breach of the 'do no significant harm' principle, and is confined to deep geological disposal. One such facility is under construction in Europe, and many countries, including the UK, are implementing policy to follow suit.

Stakeholders questioned on nuclear energy in the Taxonomy almost unanimously opposed its inclusion on the basis that the half-life of spent nuclear fuel is simply too long to make a firm assessment, and a sustainable approach should be precautionary by default. A recommendation on nuclear energy, unlike energy from natural gas, is beyond the remit of this report. The APPG would simply emphasise that the absence of nuclear energy from the Taxonomy would simply mean it is not a green source of energy, but can still be viewed as viable to reach net zero.

2.2.2. Financial data

The EU Taxonomy treats financial data, namely CapEx, OpEx and turnover, differently from one another. Based on testimony and research undertaken by the APPG, turnover is used to indicate present Taxonomy alignment, while CapEx is an indicator of investment and therefore a window into the future – OpEx is widely viewed as a far less useful data point. Under the EU's Non-Financial Reporting Directive (NFRD), firms with more than 500 employees are required to report how much of their OpEx, CapEx and turnover are Taxonomy aligned.

The EU Taxonomy covers less than half of economic activity, which the APPG is comfortable with, provided that the majority of emissions and environmental hazards are accounted for[17.] However, the group believes businesses and activities outside this higher emission and degradation category should be encouraged to use the Taxonomy.

Elizabeth Gillam, a member of GTAG and the International Regulatory Strategy Group (IRSG), who spoke to the APPG in a personal capacity, recommended that CapEx be used to help incentivise green investments.

17 European Commission, 'FAQ: What is the EU Taxonomy and how will it work in practice?'

Gillam cited the example of the EU Technical Expert Group's recommendation that real estate CapEx expenditure directed towards reducing carbon emissions by 30% should be Taxonomy aligned and suggested this approach should be rolled out across the board, including higher emitting sectors, such as transport, where the transition to net zero is fraught with difficulty, accordingly all transitional pathways should be explored rigorously.[18]

Financial experts consulted for this report strongly associated CapEx with transition. If transitional taxonomies (see section 3.2.) and frameworks are to be the main driver towards reaching long-term environmental objectives like net zero, CapEx needs to be placed on an "equal footing with turnover", to quote Elizabeth Gillam's own report on the EU Taxonomy.[19]

Elevating CapEx, in Elizabeth Gillam's view, should be part of a greater focus on "dynamic transition", whereby investors should engage with the companies they invest in to drive "positive incentives" throughout the value chain.

The emphasis on the entire investment value chain is a reminder that financial services and corporates have had little opportunity to feed into the Government's work. Martina Macpherson, Advisory Board member of the APPG said at the group's roundtable discussion on the Green Taxonomy that the "policy, regulatory and market implications" throughout the value chain needed to be discussed, with the participation of important stakeholders like investors, rating agencies and corporates.

Martina Macpherson, who is a published author and expert in ESG, and sustainable investing, and the head of sustainable (ESG) products at a major, global financial institution, strongly urged that these discussions take place, which further underlines the need for the UK Treasury to publish the consultation so that a thorough discussion with key stakeholders can take place among commercial stakeholders, as soon as possible.

Section recommendations

- To recognise capital expenditure (CapEx) spending as the key indicator of investment in transitional assets and technologies.
- To hold a transparent discussion on whether to commit to declining thresholds over a set timeline.
- To encourage wider use of the Taxonomy, even among companies with a lower environmental footprint.

18 European Commission EU Taxonomy Compass, 'Renovation of existing buildings'

19 Invesco, 'The Grand Green Plan The EU Taxonomy as a Tool to Identify the Opportunities of the Green Industrial Revolution', authored by Elizabeth Gillam, June 2021

2.3. Usability

Achieving adequate usability of the Taxonomy is reliant on being able to translate scientific research into a practical system. It must be understandable, if not necessarily easy to understand, and as unburdensome as possible.

The Taxonomy will only go so far in facilitating more standardised data. Phil Fitz-Gerald of the Financial Reporting Council (FRC) told the APPG that in order to provide meaningful information to facilitate an effective Taxonomy, companies need to establish suitable frameworks and systems for processing data internally. If the data flowing up the reporting chain is not of sufficient quality, the Taxonomy will fail.

The FRC Lab has been active in helping corporates in this regard. Its report on ESG data for companies sets out how they can develop their systems to process this data and includes practical guidance[20]. Other organisations like Principles for Responsible Investment (PRI), a UN-backed signatory group, are active in this domain too. Nevertheless, usability needs to be prioritised or we risk creating a disclosure landscape with a false sense of security.

Special consideration should be afforded to SMEs with regard to usability for the simple reason that they typically lack resources, but are increasingly expected to provide disclosures. The sustainability director at a global tech firm mentioned in the previous section pointed out to the APPG that the language and terminology used in new standards and frameworks should be simplified to help SMEs who haven't started yet on their disclosure journey to do so.

This section chiefly concerns the 'do no significant harm' (DNSH) principle that applies to all six environmental objectives, regardless of the environmental benefits a given economic activity may deliver. However, based on the consensus forged by the APPG's consultation for this report, and documentation provided by groups like PRI, DNSH is beset with issues ranging from demanding too much data – which is often not available – and expertise, while providing too little guidance.

DNSH is often criticised for not being user-friendly. In October 2022, the EU's Platform on Sustainable Finance, published Taxonomy usability recommendations, directing criticism at the way DNSH is governed by the EU Taxonomy[21].

The document states:

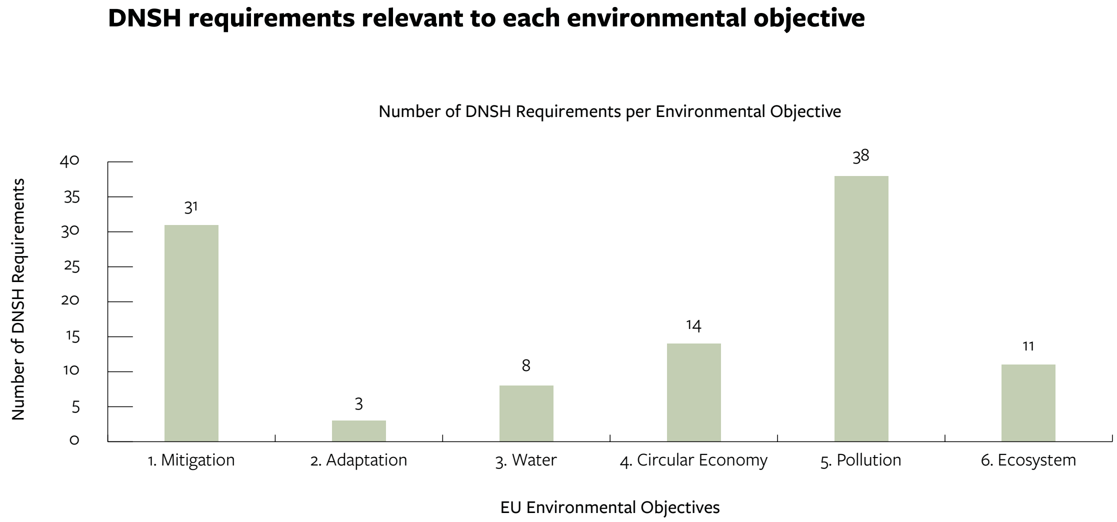
> *DNSH thresholds might already entail significant effort for investments and companies in geographies where the capacity to fulfil the criteria is lacking. This is particularly true for companies in medium and small size emerging markets. The Platform recognises that some criteria might be impossible to fulfil until the necessary capacity, infrastructure or regulatory framework are more developed. While in many places the levels of infrastructure and technological advancement remain underdeveloped, they vary tremendously between regions and within countries in the emerging world. A solid and rigorous process should be put in place to avoid any misuse or greenwashing.*

20 Financial Reporting Council, 'FRC Lab report: Improving ESG data production', August 2022

21 EU Platform on Sustainable Finance, 'Platform Recommendations on Data and Usability,' October 2022

A study conducted by FTSE Russell identified 105 separate DNSH requirements, which aside from being numerous and unevenly distributed (see Figure 4.), involve "extensive" data obligations22. Several stakeholders, including UKSIF, IRSG and PRI, highlighted how problematic DNSH is in terms of usability.

Figure 4. Uneven distribution of DNSH requirements (FTSE Russell)



The 'do no significant harm handbook' features a case study of a development project in the EU, under which, 25 economic activities needed to be accounted for with the use of granular data that is often impossible to recover, among other requirements23. Such a project would be a considerable undertaking for a green bond fund, which would likely comprise several projects and bonds. The International Capital Market Association (ICMA) notes that "the scale of the conversion and data extraction challenge cannot be overstated in these cases"[24].

ICMA cites another example of 52 EU building councils, only one of which was Taxonomy aligned. Further, the organisation notes that some DNSH criteria, notably for climate change adaptation, led to more data gaps than others. Another challenge is the deficit in expertise, noted in both ICMA and PRI publications, that places SMEs in particular at a disadvantage.

Additionally, there is a clear link between burdensome DNSH requirements and low-level alignment, which means the EU Taxonomy, as it currently stands, is potentially denying otherwise worthy sustainable projects of investment, when its purpose is to do the very opposite.

22 FTSE Russell, '"Do No Significant Harm" and "minimum safeguards" in practice – navigating the EU Taxonomy Regulation', December 2021

23 Maples Group, ELS, FS-UNEP, *Do no significant harm handbook – what, why and how of DNSH across environmental and social sustainability-related factors*, December 2021

24 ICMA, 'Ensuring the usability of the EU Taxonomy, February 2022

One solution would be to fold DNSH into the baseline social and environmental safeguards, essentially removing the middle of the Taxonomy's three-level hierarchy and filling out the third. Under this model, businesses and projects would face considerably fewer requirements outside tier one, 'significant contribution'. Elizabeth Gillam suggests this simplified model could be differentiated for equity financing and issuers of sustainable project finance and green bonds.

However, there are fears this approach would sacrifice too much substance. As a consequence, the UK would be far short of setting a high Green Taxonomy standard. Moreover, given that the substantial contribution criteria are limited to climate change adaptation and mitigation, for the foreseeable future, we would be faced with a climate change Taxonomy, not a green one.

Figure 5. Common usability issues with the EU's Taxonomy and associated regulations

Data requirements are too granular
Too often the data is obscure and unavailable. The PRI gives the example of green bonds, whereby the substantial contribution criteria are feasible, however with DNSH, almost none of the participants could be sufficiently assessed due to the unavailability of granular data at the project level.

Reliance on EU legislation
The EU Taxonomy is firmly embedded within wider environmental regulatory frameworks. An unfortunate consequence is that the Taxonomy, particularly with DNSH, is designed to fit within these frameworks. As a consequence, many references are unrecognised and unfamiliar outside the EU. This is problematic for EU companies with operations outside the internal market, while non-EU entities receiving FDI from the EU investors struggle to verify their compliance.

Inconsistency in the use of estimates
In the absence of the necessary data, the EU permits the use of "complementary assessments and estimates on the basis of information from other sources", but not across the board. This contingency cannot apply to green asset ratios and green investment ratios.

Lack of consideration for smaller businesses
The majority of the EU's TSC requirements do not make accommodations for smaller enterprises, even though the EU's own Taxonomy regulation recommends lighter treatment for SMEs.

In any case, investors seek a *green* taxonomy as many prioritise other environmental objectives over climate change; and DNSH, as developed by the EU, sets a robust baseline for all six environmental objectives. As one stakeholder who spoke to the APPG put it: "we cannot fix some of the major global problems if we're trashing nature and biodiversity." Besides, suppressing DNSH would only solve part of the problem. The APPG received testimony that the EU's substantial contribution criteria are not user-friendly either.

The solution lies with doing the utmost to make DNSH thresholds less burdensome. This will be challenging however. The APPG is mindful of Professor Thornley's comment in one of the evidence sessions that the Taxonomy does not have to absolutely reflect reality – "we don't want to do endless calculations" – the group encourages Government departments to explore greater use of proxy data as a means to address the granular data deficit. For the most part, however, the group feels the solutions lie in more consultation and more guidance.

The need for practical guidance is certainly apparent in the context of the EU Taxonomy. A member of the EU platform gave a clear example of what not to do, when they remarked to the APPG that certain DNSH criteria are largely unusable by the business and financial services community. Another expert in this domain referred to the European Commission's FAQs, which are commonly used by businesses, and the EU Taxonomy Compass.[25]

Stakeholder groups like UKSIF, ICMA and PRI also have an important role to play. The PRI's 2021 report: 'Testing the Taxonomy – insights from the PRI Taxonomy practitioners group' is an excellent example of a practical, user-friendly resource that helps businesses meet the EU Taxonomy's requirements[26].
The PRI and other organisations of its kind should be invited to provide materials for the UK market and feed into the Government's own guidance.

Recommendations

- Ensure the Taxonomy does not require businesses to chase perfect data, instead provide options for proxy data and assumptions, accompanied by user-friendly guidance.
- Recognise that there is a deficit in the necessary skills and expertise enabling businesses to comply with the Taxonomy and seek policy solutions.
- Ensure that necessary stated objectives such as usability are met using accompanying regulatory frameworks and delivery of the Taxonomy.
- Useful and user-friendly guidance on how to use the Green Taxonomy and meet disclosure requirements.

2.4. Interoperability

In onshoring the EU Taxonomy with the objective of improving it, the UK has an opportunity to become a Green Taxonomy leader globally. The mission at hand is to first learn from the EU's errors and experiences and to then help other countries converge.

25 European Commission, 'FAQ: What is the EU Taxonomy and how will it work in practice?'

26 UNPRI, 'Testing the Taxonomy, insights from the PRI Taxonomy practitioners group' 2021

Before addressing convergence, it is necessary to demonstrate why interoperability is a priority. Sara Lovisolo, head of sustainability at Euronext and a former member of the EU's Technical Expert Group, told the APPG: "Investors are global, they invest in companies across different geographies. They're not used to tailoring an Exchange-Traded Fund to a specific market. The Taxonomy has to be broad so that it can raise capital across geographies."

Put simply, higher interoperability means more access to purchasers of bonds and equities, it is therefore a priority. The nightmare scenario is multiple Taxonomies that are completely inconsistent with one another, leading to market fragmentation, and greater burden for businesses.

This is a vital consideration for the UK, not least due to enduring UK and EU economic interdependence. Another key factor is that many other countries will adopt the EU Taxonomy, much like the UK has. This section will finally explore bringing about convergence with very different taxonomies, such as China's and Singapore's.

2.4.1. Interoperability with the EU

The UK's decision to adopt the functionality of the EU Taxonomy is wrapped up in the interoperability equation. Were the UK to choose not to adopt the EU Taxonomy, businesses would see their compliance costs rise, placing a significant obstruction on the flow of global green finance, hence the UK's decision to onshore the EU's alignment criteria wholesale.

The same principle applies to the metrics selected by the EU. Businesses will still face prohibitive costs if they are not the same. The APPG, therefore, takes the view that the UK should adopt the same metrics, except in those instances where it is unavoidable (see case study below). For instance, metrics selected by the EU in construction do not apply in the UK context, meaning alternatives need to be identified.

Case Study: Buildings

The Green Technical Advisory Group has identified issues with applying the pollution prevention and control DNSH for TSC 7.2: 'Building components and materials used in construction do not contain asbestos nor substances of very high concern as identified on the basis of the list of substances subject to authorisation set out in Annex XIV to Regulation (EC) No 1907/2006 of the European Parliament and of the Council.'

TSC 7.2 cannot be easily applied in the UK because labelled products do not currently exist for all chemical substances under the EU's REACH regulation (1907/2006), which consists of a directory of substances, thresholds for exposure – such as asbestos – and use.

GTAG advises the UK Government to "reflect this at least in the near-term, as adequate capability is developed in the UK".

Source: Green Technical Advisory Group: 'Advice on the development of a UK Green Taxonomy'.

The GTAG secretariat informed the APPG that TSCs can be adapted to suit the UK's circumstances with relatively little additional burden for businesses – the underlying metrics and data should of course be the same. Based on the information given to the APPG, the group favours differentiation in this area, provided it is grounded in scientific evidence and helps to ensure the integrity of the UK Taxonomy. Reducing burden and enhancing usability remains a key consideration, however.

The other consideration is that the more aligned with the UK is with the EU's Taxonomy, the greater the likelihood of accessing green investment. Certainly, the appetite is there, in September 2021 the UK issued its first green gilts, raising £10bn for green projects across the country, the largest issuance of its kind anywhere in the world. The order book was 10 times oversubscribed. Judging by CBRE Investment Management's positive experience (see case study below) a robust Taxonomy is an essential asset in leveraging green finance.

Case Study: CBRE Investment Management

In 2021, CBRE Investment Management (CBRE IM), a global real assets investment management firm with $143.9bn under management, raised €1bn in two issuances for green bonds. The bonds were raised on behalf of a green fund sponsored by CBRE IM.

For the second issuance, totalling €500m and raised on the euro market, CBRE IM aligned its Green Finance Framework (GFF) with the EU Taxonomy, thus helping to meet market expectations and reduce the risk of 'green' being interpreted as CBRE IM's own opinion.

The GFF was also aligned with:

- The International Capital Markets Association's Green Bond Principles
- Loan Market Association's Green Loan Principles

The Green Finance Framework was assessed and approved for accuracy and integrity by Sustainalytics, acting as SPO (Second Party Opinion) provider. The Fund allocates 100% of the net proceeds from the issuance of each Green instrument (loan or bond or any other financing instrument) to green projects ("Eligible Green Projects") satisfying one or more of the eligible indicators and performance requirements.

CBRE IM identified three clear positives:

- It allowed refinancing according to ambitious green KPIs
- Provided the opportunity to mobilise green finance in the form of green bonds
- The issuance through the GFF/Green Taxonomy was financially beneficial, being oversubscribed with positive returns for the business

In CBRE IM's view, the EU Taxonomy helped facilitate a successful Green Bond, indicating that the UK Taxonomy could help drive similar green finance activity in the UK.

Source: CBRE Investment Management – $143.9bn as of September 30, 2022

2.4.2. Convergence with principles-based Taxonomies

Beyond the UK's borders, the interoperability mission falls into two streams. One is to take the new UK Taxonomy and support partners internationally to adopt and learn from (see section 3.1.). The other is to build bilateral and multilateral assets to help bridge the gap between the UK Taxonomy and contrasting, principles-based Taxonomies such as China's.

Figure 6. Comparison between EU Taxonomy and China Green Bond Endorsed Project Catalogue

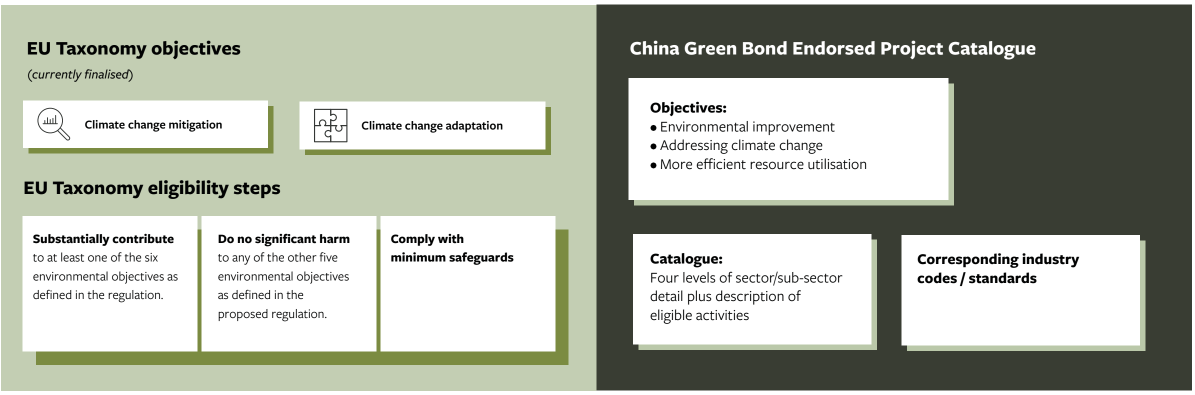


Figure 6. illustrates the dissimilarities between the structure and outlook of the EU and Chinese Taxonomies. To at least partly remedy this considerable gap, the EU and China have undertaken an in-depth comparison exercise called the 'Common Ground Taxonomy' (CGT)[27]. Paula Redondo, Head of Regulatory Affairs at the Luxembourg Stock Exchange and a former member of the EU's Technical Expert Group, defined the importance of the CGT's work to the APPG as follows:

> *By facilitating dialogue between policymakers, the International Platform on Sustainable Finance plays a key role to mitigate Taxonomies fragmentation across jurisdictions, improving the comparability and future interoperability of Taxonomies around the world. Helping identify the commonalities and differences between approaches will lower the trans-boundary cost of green investments and scale up the mobilisation of green capital internationally. Harmonising all significant Taxonomies, including the UK one, and having an outcome that is usable by market participants will be critical.*

27 International Platform on Sustainable Finance, IPSF Taxonomy Working Group Co-chaired by the EU and China, 'Common Ground Taxonomy – Climate Change Mitigation'

The APPG supports engagement such as that taken by the EU in creating resources that translate one Taxonomy to the other, although such an undertaking is fiendishly complex. The EU and China have begun work towards the Common Ground Taxonomy by identifying "clear overlaps" between activities that can be considered comparable[28]. Meanwhile, the Singapore Green Task Force, which presides over another principles-based Taxonomy, has begun leveraging common industry standards with international partners. The APPG recommends outreach of this kind with the caveat that external stakeholders, particularly businesses that use both taxonomies, are involved in the process as their insight will be invaluable.

Section recommendations
Establish bilateral and multilateral green Taxonomy platforms to facilitate greater interoperability, particularly with principles-based taxonomies.

3. Leadership and implementation

3.1. UK leadership worldwide

Asserting global leadership in sustainable finance is a clear objective of the UK Government. Not only is the United Kingdom home to a global financial centre, it has built considerable momentum internationally, driving the sustainability agenda.

The *Greening Finance Roadmap,* published a few weeks in advance of COP26 in Glasgow states: "As part of the G7, the Government brought climate and environmental issues to the forefront of policy discussions between finance ministries. This was the first time these challenges featured prominently in the Finance Track"[29].

The UK doubled down on its commitment to encouraging sustainable finance, and keeping 1.5C alive, at COP26 shortly afterwards. The UK's Presidency of COP ended with over 90% of the world's GDP covered under net zero commitment and, crucially for green finance, the massive commitment of financial institutions to sustainability – 450 firms with $130tn of assets under management committed themselves to net zero at Glasgow.

28 Ibid

29 HM Treasury, 'Greening Finance: A Roadmap to Sustainable Investing', October 2021

A year on from COP26, the APPG believes HMG needs to help reassert the UK's presence globally to keep the momentum going. The first act would be to release the Taxonomy consultation, followed by the launch of the Taxonomy itself. In its October 2022 'advice' document, GTAG called for the UK to send out a "rapid market signal" as to how the EU Taxonomy will be adopted and the extent to which it will "reflect UK-specific needs"[30]. The APPG would suggest such a signal would also inform international partners that second-mover advantage is not about to be relinquished. Whatever the signal, the APPG recognises that the UK needs to give a clear indication that it will launch the taxonomy if it is to establish a leadership position to help other jurisdictions with the development of their Taxonomies.

Certainly, in the APPG's view, UK leadership is needed. One asset manager who spoke to the APPG said that under TCFD reporting there is a natural inclination towards developed over emerging markets. Moreover, the framework conditions are such that it is more beneficial from a TCFD scoring point of view to invest in sectors like pharmaceuticals than carbon-intensive industries such as steel (see section 3.2. on transition). One of the key pillars of the COP27 implementation plan was to support developing countries, which serves to highlight the importance of establishing a Taxonomy that does not automatically favour developed economies[31].

Europe only accounts for a fraction of the global investment needed to address climate change compared to Asia and Africa. It is hoped that issues with TCFD will resolve themselves with the introduction of the UK Green Taxonomy. There are intrinsic biases within the EU Taxonomy that favour investment in developed markets. According to Elizabeth Gillam, at least part of the problem is that the necessary data is often harder to source in developing economies, thereby skewing reporting and therefore investment towards developed markets. This underlines the UK's mission globally, namely, to engage internationally and level the playing field using all existing multilateral platforms and bilateral partnerships in coordination with commercial stakeholders, a key recommendation of this report.

Meanwhile, the City of London provides the UK with visibility of the deficiencies in the global green finance marketplace and any clashes with the EU Taxonomy that the UK may be able to resolve through engagement. For instance, following on from the previous section on interoperability, an EU metric that is unsuitable for the UK, may be just as unsuitable in other parts of the world. In such instances, the UK should consult internationally and work with the EU towards greater convergence involving as many jurisdictions as possible.

In 2023, the International Sustainability Standards Board (ISSB), launched at COP26, will introduce a global baseline for disclosures. Consultations were put out this year for both a sustainability reporting standard and climate reporting standard. The two will help drive convergence, but only to a certain degree. In its response to the APPG's call for evidence, the Confederation of British Industry (CBI) noted that taxonomies are not part of the ISSB's current scope, pointing to a gap in coordination the UK can help fill by advocating for further cooperation on taxonomy convergence internationally.

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30 Green Technical Advisory Group and the Green Finance Institute, 'Advice on the development of a UK Green Taxonomy', October 2022

31 United Nations Framework Convention on Climate Change, 'Sharm el-Sheikh Implementation Plan', November 2022

Unlike other international sustainability frameworks, such as ISSB or TCFD, there is no single body or organisation devoted to green taxonomy convergence, which presents the UK with both an opportunity for leadership and an interoperability challenge.

The CBI suggests:

> *Given the UK's international capital markets and good transatlantic connections, the Government should show international leadership to promote more international convergence on Taxonomies at both the G7 and G20 level. It could also use the GTAG's expertise to provide solutions on how to promote international interoperability.*

The *Greening Finance Roadmap* highlights the active role played by the UK in the G20's Sustainable Finance Working Group (SFWG) in the discussion on aligning investments with sustainability goals. The UK is also a member of the International Platform on Sustainable Finance (IPSF), which aims to foster consistency in environmental impact reporting.

In 2021, the SFWG and the IPSF, in partnership with the United Nations Department of Economic and Social Affairs (UNDESA), contributed to the aligning investment dialogue with an input paper[32]. It is noteworthy that the authors of the EU-China Common Ground Taxonomy's inaugural report state that their work dovetails with the SFWG/IPSF work input paper. This suggests that the UK would be well-advised to deepen its engagement in this domain by undertaking rigorous research and analysis, enabling it to contribute meaningfully at the international level. Engagement would be profoundly helped by the launch of the UK's own Taxonomy. The APPG notes that GTAG will soon publish advice on international interoperability.

The bilateral dimension also needs consideration. A participant at the APPG's Green Taxonomy roundtable suggested that the UK, once its Taxonomy is up and running, could assist partners such as Canada in developing theirs. Engagement could work both ways. New Zealand's Taxonomy is primarily focused on agriculture, the UK could assist with its expansion. UKSIF told the APPG that one improvement on the EU Taxonomy would be to place greater emphasis on decarbonising agriculture, thus in return, New Zealand could help provide solutions for the UK. The APPG is optimistic that flourishing Green Taxonomy dialogue would lead to positive collaboration in other aspects of the environment and ESG.

32 IPSF-UNDESA input paper for the G20 SFWG, 'Improving compatibility of approaches to identify, verify and align investments to sustainability goals', September 2021

Recommendations

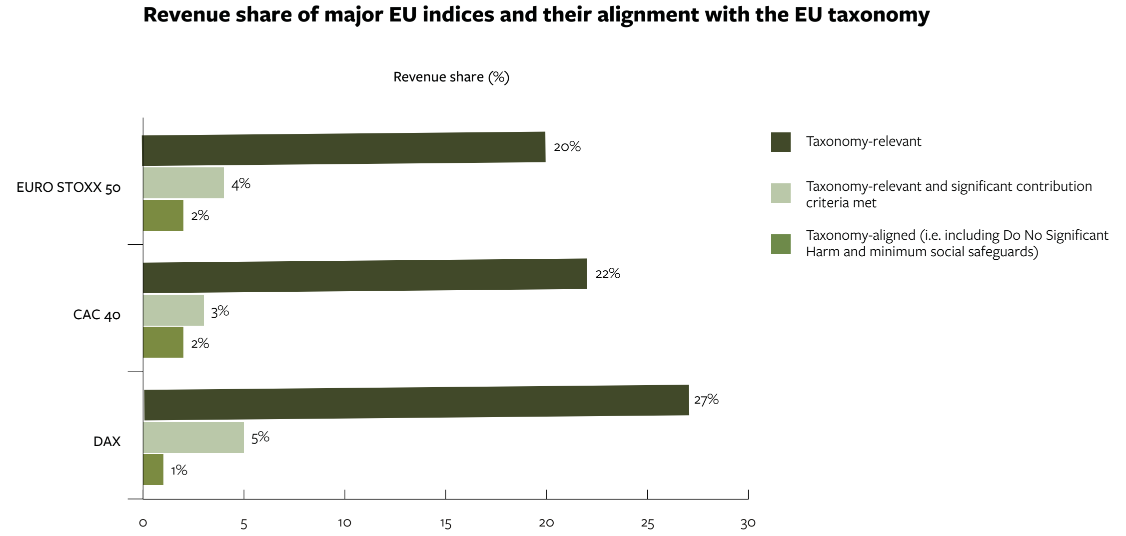
- Engage with and support global partners developing their own green taxonomies in order to facilitate greater interoperability and learn best practice.
- For the UK to be active globally in publishing, in coordination with international organisations and other states, robust and evidence-based analysis and solutions to assist the Green Taxonomy agenda worldwide.

3.2. Transition

The APPG favours a transitional taxonomy of one kind or another, and views such an instrument as necessary. This would be a useful asset for investors conscious of the need for statistically sound transition plans, and for businesses seeking to reduce their carbon footprint. However, such a policy tool must not be overly burdensome, a balance the APPG acknowledges will be difficult to strike.

Two factors to consider here are first that a Green Taxonomy accounts for a small percentage of economic activity. adelphi/ISS's 2020 European Sustainable Finance Survey found that Taxonomy-aligned revenues derived from large listed companies represented less than 3% of the total (see Figure 7.)[33.] As one testimony to the APPG put it, "green activities alone will not create real-world change".

Figure 7. Level of alignment of publicly listed companies in the EU with the Taxonomy



Source: Adelphi/ISS, October 2020

33 adelphi and ISS ESG, 'European Sustainable Finance Survey 2020'

Should, therefore, the Taxonomy be reconfigured to meet both ends, or tilted towards transition? This is problematic, as the Green Taxonomy should be binary if it is to effectively address greenwashing. This comes with the caveat that according to the *Roadmap*, the UK Green Taxonomy will include 'enabling activities', such as the manufacture of wind turbines. While these assets are not typically made up of sustainable materials, they support the transition away from fossil fuels and are therefore exempted. Furthermore, transitional activities will be reviewed every three years, meaning that over time, some will be jettisoned when they are no longer assessed to help drive transition.

However, a binary Green Taxonomy can still be a useful transitional tool. Businesses can use it to demonstrate their current level of alignment and project forwards. A given company could be 5% aligned in year one, with plans to be 15% aligned in year five. The KPIs can be used to leverage loans, whereby the interest rate is increased if the KPI is not met. A prerequisite would be for the company in question to prepare adequate transition plans.

The APPG is sceptical that the market will operate entirely in this fashion though. One explanation given to the APPG for the fierce lobbying to the EU for natural gas and nuclear energy to be included as 'transitional' fuels is that being classified as non-green would prohibit investment.

This depiction may seem exaggerated and touches on the EU's failure to present the Taxonomy as a green tool first and foremost, however testimony given to the APPG by the producer of a carbon-intensive but strategically important material said they were deeply concerned by their lack of access to credit, in spite of green investments, such as carbon capture and storage (CCS). This is cause for concern, suggesting wider consultation is needed with market participants.

Aside from enabling activities, the APPG does not support the inclusion of transitional exemptions such as natural gas, instead, they should be placed in an appropriate transitional instrument. Doing so would help signify the Green Taxonomy is truly green. Given the EU Green Taxonomy's small degree of alignment with the wider economy, the tool that will do the most to deliver net zero and other sustainability objectives is likely to be a separate one with the label: transition.

One model for a Taxonomy that has been widely floated is for a green, amber, and red system signifying sustainable, low-carbon and carbon-intensive activities. The APPG sees two drawbacks with such an approach, based on testimony from experts consulted for this report.

First, the reporting and disclosure burden stemming from three instead of just one classification would be an order of magnitude higher. It seems highly unlikely that such a system could be developed without causing a tremendous burden on businesses, particularly smaller ones.

The second issue is politicisation. The EU's difficult experience attempting to isolate sustainable activities is a warning to not invite more opposition than is strictly necessary. Understandably, carbon-intensive sectors will fight hard to avoid being designated red industries for fear of the cost of capital rising. Their lifeline will be to show credible transition plans, the transitional taxonomy must help them to this end rather than the opposite.

The APPG shares UKSIF's view that the next priority is addressing transitional economic activities, including through climate transition plans or potentially a transitional taxonomy. Thus, the APPG advises the UK Government to consider a transitional instrument.

Section recommendation
Signal the introduction of a transitional taxonomy as the next step to function alongside the Green Taxonomy as soon as possible.

3.3. Disclosure frameworks

There was broad consensus among contributors to this report that a Green Taxonomy is of little use if it does not sit within a wider disclosure framework.

"There could be a situation where the Taxonomy exists, but is floating around in the ether, and there's no regulatory underpinnings to make companies report against it. I think that it undermines the effectiveness," remarked one contributor to the APPG's roundtable discussion, in response to concerns that the Green Taxonomy may be voluntary only.

A corporate governance expert who participated in the roundtable expressed their concerns that without mandatory disclosures, there will not be the necessary level of confidence in the market. "Rating agents' listings might double down and be even stricter, in order to avoid claims of greenwashing," they told the APPG.

The other concern is that the UK economy will be one step further away from transition without a Taxonomy supported by disclosure frameworks. However, that is not to say the UK Government has not been active, indeed Britain has been at the forefront of climate disclosures. In April, mandatory TCFD reporting requirements were brought into force for larger companies and financial institutions, a world first.

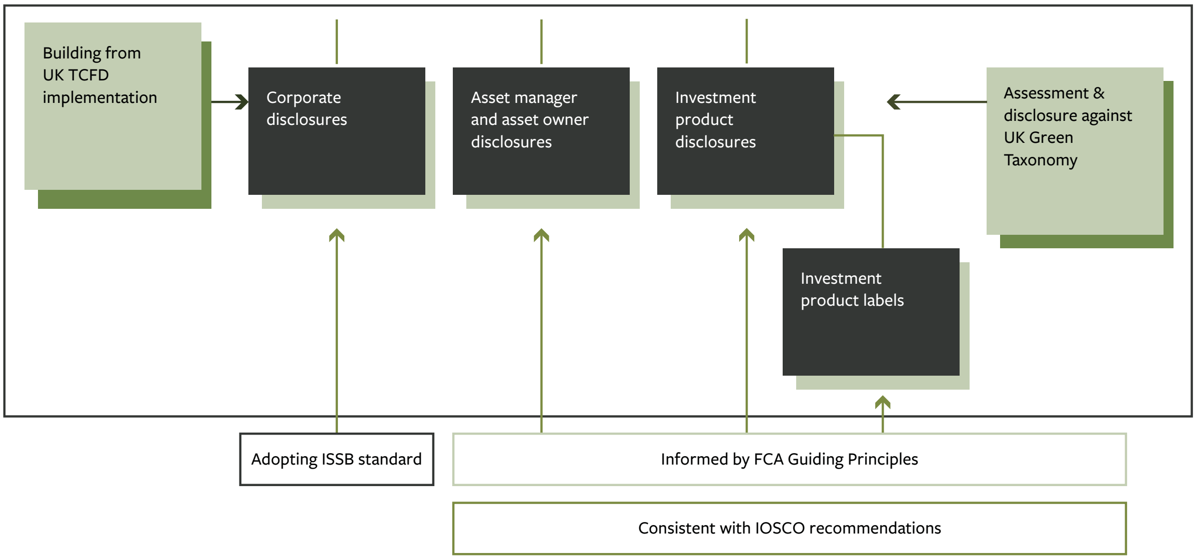
In July 2021, the Chancellor announced new Sustainability Disclosure Requirements (SDRs), which were presented alongside the Green Taxonomy in the *Greening Finance Roadmap*, published three months later[34]. The SDRs must be fit for purpose too. Based on the EU's experience with its reporting frameworks, the CBI warns that Taxonomy usability is intrinsically linked with the disclosure regime that surrounds it.

34 HM Government, 'Chancellor sets out how UK financial services can create prosperity at home and project values abroad in first Mansion House speech, July 2021

In October, following a lengthy consultation, the Financial Conduct Authority (FCA) published a landmark paper on SDR and investment labels[35]. The document presented the Taxonomy as a key component to both measure the sustainability of disclosures (see Figure 8.) and to categorise two of the three investment labels designated by the FCA. The framework is set to be finalised in 2023.

Figure 8.

Sustainability Disclosure Requirements



SMEs need to be carefully considered too. A major UK manufacturer told the APPG that sustainability reporting is a challenge due to the number of SME suppliers they rely on who do not routinely report on ESG. The manufacturer expressed concern that smaller businesses may struggle to access finance as a result. The UK's disclosure framework should therefore cover SMEs. although the APPG emphasises the need to make the requirements as easy to meet as possible and explore exemptions. Again, wider consultation is recommended.

The CBI also warned that the taxonomy's development should happen in parallel with disclosures to ensure that the whole regime is fit for purpose. "Poorly designed" disclosure requirements could lead to a "flood of information which is not decision-useful for investors and which has no tangible positive impact on green investments." According to several experts consulted, this has often been the EU's experience, and the UK should seek to benefit from its second-mover advantage and gather evidence from companies familiar with the EU framework to inform the UK's taxonomy and disclosures regime.

The APPG notes that the Government is aligning the development, and eventually obligations, of the Taxonomy with TCFD through SDRs, and looks forward to the introduction of the ISSB baseline standards, which will also help shape the wider disclosure framework.

35 Financial Conduct Authority, 'Sustainability Disclosure Requirements (SDR) and investment labels', October 2022

3.2.1. Sequencing

In June, the Department for Work and Pensions' (DWP) introduced alignment metrics, which form part of emissions intensity metrics under TCFD reporting[36]. The head of sustainability at an asset management firm with a focus on responsible investment consulted for this report credited the DWP with helping to instigate action from other departments and regulators through the introduction of the alignment metrics. However, they would like to have seen the DWP's intervention arrive later in the sequence, with other departments showing similar initiative. This is because the alignment metrics' rely on the Green Taxonomy, which of course, is not yet in place.

Similarly, another contributor remarked that due to the DWP's early move, investors are obliged to use either a binary alignment metric, such as a science-backed decarbonisation target, or implied temperature metrics, which, while intuitive, require complex modelling that is difficult to understand, and may vary between investors. The sustainability head remarked that the DWP has an obligation to protect UK pension schemes by addressing risks and opportunities associated with climate change. The missing ingredient is better coordination within Government. This comment mirrors criticism levelled by the CBI regarding SDRs.

Coordination with SDR became a focal point for the APPG on the occasion of a roundtable the group held with the FCA in October 2022, which happened to coincide with the publication of the regulator's landmark SDR and investment labels consultation. Participants at the meeting expressed their bemusement that SDR is progressing without a working definition for sustainable investment that will be delivered by the Taxonomy, which by contrast, appears all but dormant.

The CBI also warned of sequencing issues relating to the EU's deployment of green finance instruments, citing the rolling out of reporting requirements for financial institutions before corporates, even though the flow of information works in the opposite direction. The EU committed a similar error with the order it implemented the Sustainable Finance Disclosure Regulation (SFDR) and the Green Taxonomy. Meanwhile, at the international level, the UK needs to do its utmost to ensure that SDR and the Taxonomy are correctly sequenced with the ISSB's standards without causing undue delay.

Potential sequencing pitfalls are accounted for in the *Greening Finance Roadmap*, which states that a "sequenced approach" to SDR will be taken, but given the concerns raised, the APPG urges more coordination.

Recommendation

Introduce Sustainability Disclosure Requirements without delay, while ensuring they arrive in the correct sequence.

36 Department for Work and Pensions, 'Climate and investment reporting: setting expectations and empowering savers – consultation on policy, regulations and guidance', June 2022

3.4. Communication

The first section of this report emphasised the importance of clearly defining the purpose of a UK Green Taxonomy and ensuring the instrument conforms to that vision. Other sections on the EU experience emphasising the importance of placing the science first have clearly pointed towards demonstrating what a Green Taxonomy should be, namely green, and what it should not be. The APPG urges the Government to take heed of this recommendation through all appropriate channels at its disposal.

In the APPG's view, the Government has arguably a more straightforward, but easily neglected, duty to help the market function by demonstrating to consumers that green financial products are credibly green, particularly to retail investors who typically lack commercial investors' insight and technical expertise.

An executive at a major financial services company which provides a range of retail investment products, told the APPG "I think what's more pertinent will be when SDR comes in, and how to get retail investors to understand different terminology and wording that is used by professionals on a daily basis. That means nothing to the average investor".

In its October consultation paper, the FCA reiterated its proposal to implement two layers of disclosure, one for consumers and another more detailed layer for institutional investors at the product and entity level on sustainability risks, opportunities, and impacts. The APPG welcomes the proposal, but remains concerned that not enough information, packaged in the appropriate manner, is reaching consumers.

Section recommendations
Explore ways of delivering greater understanding of how the UK has ensured green retail financial products are credible, looking at best practice from overseas.

Figures Index

Glossary

APPG – All-Party Parliamentary Group
CCC – Climate Change Committee
CoRWM – Committee on Radioactive Waste Management
CBI – Confederation of British Industry
CGT – Common Ground Taxonomy
DWP – Department for Work and Pensions
ESMA – European Securities and Markets Authority
ESG – Environmental, Social and Governance
EWG – Energy Working Group
FRC – Financial Reporting Council
GFF – Green Finance Framework
GTAG – Green Technical Advisory Group
ICMA – International Capital Market Association
IPSF – International Platform on Sustainable Finance
IRSG – International Regulatory Strategy Group
ISSB – International Sustainability Standards Board
JRC – Joint Research Centre
LCA – Life-cycle assessment
NFRD – Non-Financial Reporting Directive
PRI – Principles for Responsible Investment
SFWG – Sustainable Finance Working Group
TCFD – Taskforce on Climate-related Financial Disclosures
TEG – Technical Expert Group
TSC – Technical Screening Criteria
SFDR – Sustainable Finance and Disclosure Regulation
SDR – Sustainability Disclosure Requirements
SPO – Second Party Opinion
UKSIF – UK Sustainable Investment and Finance Association
UNDESA – United Nations Department of Economic and Social Affairs

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